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Tax Implications of the Uniform Marriage and Divorce Act: Does the Davis Rule Still Apply in Kentucky?

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COMMENTS

TAX IMPLICATIONS OF THE UNIFORM MARRIAGE AND DIVORCE ACT: DOES THE DAVIS RULE STILL APPLY IN KENTUCKY?

INTRODUCTION

In the typical American household, the husband holds paper title to most of the property. This becomes significant when a dissolution of the marriage occurs. During the divorce proceedings, the husband’s appreciated property may be transferred to the wife in satisfaction of her marital rights. The U.S. Supreme Court in United States v. Davis held such a transfer to be a taxable event in common-law states where the wife’s rights to her husband’s property include only inchoate dower and a reasonable share of marital property upon divorce.

This comment will examine the Davis decision to ascertain apposite factors in determining whether a transfer of appreciated property from one spouse to the other pursuant to a divorce is a nontaxable division between co-owners or a taxable event. Also, the effect of Davis on the husband and wife in common-law states vis-a-vis federal tax treatment of the couple in community property states will be examined.

The U.S. Courts of Appeals have interpreted Davis in three different ways. A majority of the federal courts have adopted the “traditional” approach which requires that the wife possess one of the common-law indicies of co-ownership before a transfer incident to divorce will be exempt from taxation. The “equitable” approach of the Tenth Circuit affords

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1 Nemy, Feminists Look at Alimony: It's Not All Bad They Say, N.Y. Times, Feb. 6, 1976, at 37, col 1.
4 Imel v. United States, 523 F.2d 853 (10th Cir. 1975); Collins v. Comm’r, 412 F.2d 211 (10th Cir. 1969).
tax-free status to transfers in the common-law states of Oklahoma and Colorado. This approach predicates tax-free transfers at divorce upon a determination by the state's highest court that the wife possesses a species of co-ownership. This type of co-ownership results from legislative recognition of the wife's contribution to the acquisition of marital property. Finally, a "progressive" approach has been utilized by the Sixth Circuit, which has held that the state statute on disposition of marital property controls the federal tax outcome. Each of these approaches will be compared to the statutes and case law of Kentucky to determine whether transfers of appreciated property between divorcing Kentuckians are entitled to tax-free status.

I. The Federal Tax Consequences of Divorce-Related Transfers of Appreciated Property in Common-Law States and Community Property States

*United States v. Davis* controls the taxability of transfers of appreciated property by the husband when title is held solely in his name. In *Davis*, the taxpayer-husband, a Delaware citizen, transferred appreciated stock to his wife in full settlement.

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5 Imel v. United States, 517 P.2d 1331, 1334 (Colo. 1974). See also Collins v. Oklahoma Tax Comm'n, 446 P.2d 290 (Okla. 1968), where the court held that the wife had a vested interest in jointly-acquired property.


7 Swaim v. Comm'r, 417 F.2d 353 (6th Cir. 1969).

8 370 U.S. 65 (1962).

9 Should the husband transfer depreciated property to his wife, he may not be entitled to a loss deduction. First, I.R.C. § 267 prohibits the deduction of any losses in transactions between related parties, including husband and wife. See, e.g., McWilliams v. Comm'r, 331 U.S. 694 (1947). This prohibition would not apply if the property is transferred after the divorce is granted. See 95-3rd TAX MANAGEMENT PORTFOLIOS: DIVORCE AND SEPARATION, A-36 (1975). Second, I.R.C. § 165(c)(2), providing for the deductibility of losses when they are "incurred in any transaction entered into for profit," may or may not be activated in a divorce situation. The Commissioner has taken the position that a sale pursuant to a divorce decree is not a sale entered into for profit but is rather a sale motivated by personal reasons and does not qualify for the section 165(c)(2) deduction. Robertson v. Comm'r, 55 T.C. 862 (1971), acq. 1972-2 C.B. 3. The Tax Court disagreed with the Commissioner, thereby allowing a deductible loss if the asset transferred would, absent divorce, give rise to a deductible loss on its sale. *Id.*

10 The *Davis* rule would, of course, apply when the wife conveys appreciated property held in her name to the husband.
ment of her marital rights to his property. The taxpayer had a basis of more than $74,000 in the stock. At the time of transfer, the stock had a fair market value of $82,250. The issue before the Court was whether the husband should be taxed on the increase in the value of the stock.\footnote{370 U.S. at 66-67.}

The taxpayer in \textit{Davis} argued that the transfer, made in satisfaction of the couple's property agreement, was not a sale or exchange but a nontaxable division of property between co-owners. The Court examined Delaware law to determine whether the wife's marital rights could be equated with an ownership interest in her husband's property. The existence of such an ownership interest was determined by: (1) whether the wife had a right to manage or dispose of her husband's property during marriage; (2) whether the wife had a descendible share in her husband's property, that is, an interest that could pass by will or intestacy, rather than requiring that she survive her husband to share in his intestate estate; and (3) whether the wife had a right to a share of marital property other than what a divorce court determined was a reasonable share upon dissolution of the marriage.\footnote{Id. at 70.}

Under Delaware law the wife had none of the above rights. Consequently, the husband had a personal obligation to the wife which could be satisfied by the transfer of his property to her; the wife had no bona fide ownership interest in the husband's property.\footnote{Id.} A taxable event occurred when the husband exchanged stock for the release of the wife's inchoate marital rights, and, therefore, the husband was taxed on the gain. The value of the legal obligation released by the wife was presumed by the Court to be equal to the fair market value of the property transferred.\footnote{Id. at 71-72.} Thus, while the husband was taxed on his "gain,"\footnote{\textit{I.R.C.} \textsection\textit{1001(a)} defines "gain" as "the excess of amount realized . . . over the adjusted basis." "Amount realized" is defined as the "fair market value of the property (other than money) received." \textit{Id.} at \textsection\textit{1001(b)}.} the wife received the stock tax free and took its fair market value as her basis.\footnote{370 U.S. at 73. \textit{Davis} applies to the transfer of separately-owned appreciated property pursuant to a divorce decree as well as to a property settlement. \textit{Wallace v.}
On the surface, *Davis* appears to benefit wives. However, a closer examination of its effects reveals that wives are actually penalized. First, a husband naturally will be reluctant to transfer appreciated property to his wife unless the property is held jointly,\(^{17}\) preferring a cash settlement to avoid the tax consequences of the *Davis* rule.\(^{18}\) At least one court has condoned the transfer of cash instead of property even when the wife had been granted a 40% interest in the marital property.\(^{19}\) In this situation, the cash the wife receives is a fluid asset which will depreciate with inflation if not invested soon after the divorce, instead of property which will appreciate in value.

The *Davis* decision may also result in an increased tax burden on the wife.\(^{20}\) Since alimony is deductible from the husband's gross income\(^ {21}\) and is taxable as ordinary income to the wife,\(^ {22}\) the husband may attempt to shift the tax burden by characterizing cash payments to the wife as maintenance and support; even though in reality they are in satisfaction of the

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\(^{17}\) See note 16 *supra* regarding the nontaxability of jointly-held property.

\(^{18}\) See *Clark v. Clark*, 487 S.W.2d 272 (Ky. 1972), where the husband structured a property settlement to avoid paying capital gains tax on the transfer of real property pursuant to a divorce. In lieu of her court-ordered 40% share of the property, the wife received cash installment payments over an eight-year period.

\(^{19}\) *Id.* at 275. In *Clark*, the wife argued that the property should have been divided in-kind or sold and the proceeds apportioned. Since the property contested was a business estate, the Court held that its "division or forced liquidation . . . could materially depreciate its value and could destroy the basis of the husband's earning capacity. In [such] circumstances it is proper to allow the wife the value of her share in cash, payable in installments." *Id.*

\(^{20}\) See, e.g., *West v. United States*, 332 F. Supp. 1102 (S.D. Tex. 1971), *aff'd*, 477 F.2d 563 (5th Cir. 1973), where the wife received 121 monthly installments as a divorce settlement. The wife contended that the payments represented her portion of the jointly-acquired property and thus were not taxable. The payments were held to be alimony and therefore taxable as ordinary income to the wife and deductible by the husband.

\(^{21}\) I.R.C. §§ 101(e)(1), 215.

\(^{22}\) I.R.C. § 71.
wife's claim to marital property. On such a transfer, which settles the wife's property rights, the husband is not entitled to a deduction and the wife is not subject to a tax. However, in a dispute with the Commissioner, the taxpayer bears the burden of proving the transfer was a property settlement and not maintenance and support, or vice versa. In determining the true nature of the payments, the courts make their own examination based on several relevant factors; labels attached by the divorce court or the parties are not necessarily controlling. Thus, if the husband holds legal title to the bulk of the property and claims an alimony deduction, the wife bears the burden of proving that the cash settlement was for the relinquishment of her property rights.

By contrast, the wife in a community property state is a co-owner of the marital property. Consequently, under the

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22 See note 20 supra for the summary of a case where this situation occurred. See also Mills v. Comm'r, 54 T.C. 608 (1970), aff'd, 442 F.2d 1149 (10th Cir. 1971); Jocalin v. Comm'r, 52 T.C. 231 (1969), aff'd, 424 F.2d 1223 (7th Cir. 1970).
27 To qualify as alimony, the payments must be either periodic or in installments over more than a 10-year period. I.R.C. § 71. If the payments do not meet the above criteria, then they will not be included in the wife's gross income.
29 The eight traditional community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington. 4A R. Powell & P. Rohan, Powell on Real Property § 624.2 (rev. arb. ed. 1975).
30 Poe v. Seaborn, 282 U.S. 101 (1930). In Poe, the taxpayer-husband, a Washington citizen, was the sole wage earner who held all the community property in his name. Nonetheless, the husband and wife each reported one-half of the total community income on separate federal income tax returns. The Court examined the wife's rights in the community property under state law by considering factors similar to those in Davis. See text accompanying note 12 supra for an enumeration of the Davis factors. The Court determined that the husband had complete control over the management and disposition of the community property. In addition, both the state court and the Supreme Court held that the wife had a vested interest in the community property. The husband and wife were thus entitled to separate returns, each including one-half of the community income. 282 U.S. at 108-11, 118.
Davis rule, no taxable event occurs when appreciated property is equally divided between the spouses pursuant to a property settlement agreement or court decree. The husband in a community property state is, therefore, not encouraged by federal tax law to settle with his wife in cash rather than in property. The obvious disparity in the tax treatment of divorce-related transfers in common-law states and community property states was recognized by the Court in Davis. Nevertheless, the Court brushed aside this unequal treatment of husbands and wives in common-law states as a "fact of life" that only Congress could remedy.

II. Interpretation of Davis: Three Approaches

A. The Traditional Approach

The traditional approach has been advocated by the majority of federal courts and the Commissioner of Internal Revenue. This approach reasons that Davis established federal criteria which "must be met before the rights conferred by state law can be said to constitute ownership." The wife is deemed a co-owner if she has a right under state law to manage or dispose of her husband's property, the right to a descendible share of the property, or the right to a share of her husband's property beyond merely a reasonable share upon divorce. The divorce-related conveyance of the husband's property is subject to taxation if the wife possesses none of these rights.

Note, The Federal Income Tax Consequences of Property Settlements in Common Law States and Under the Uniform Marriage and Divorce Act: A Proposal, 29 Me. L. Rev. 73, 81 (1977). See also Rev. Rul. 74-347, 1974-2 C.B. 26, which states that co-ownership of property exists for federal tax purposes when "(1) title ... is taken jointly under State property law, (2) the State is a community property law State, or (3) State property law is found to be similar to community property law." 370 U.S. at 71.

31 Note, supra note 3 for a citation of cases that follow the traditional approach.
32 Id.
33 See note 3 supra for a citation of cases that follow the traditional approach.
34 Collins v. Comm'r, 412 F.2d 211, 212 (10th Cir. 1969).
35 Id. at 212.
36 The wife would also be a co-owner if she held title to the property jointly with her husband. See note 16 supra for cases supporting this principle.
37 All three factors are not required for the wife to be deemed a co-owner. See Note, supra note 32, at 82-87.
38 370 U.S. at 70.
39 Id.; Wiles v. Comm'r, 499 F.2d 255, 257-58 (10th Cir.), cert. denied, 419 U.S.
Examination of Kentucky law reveals the absence of the first two indicia of ownership. First, neither the husband nor the wife has a right to manage or dispose of the other's separately-owned property. Second, dower rights in Kentucky do not include a right to a descendible share, that is, the wife's rights in her husband's property cannot pass by will or intestacy. In fact, once a divorce is granted, all claims to dower are barred. Nonetheless, there are two Kentucky cases which characterize dower as a property right that "vests" during marriage. In community property states the wife is considered a co-owner because she has a vested interest in the community property during coverture. Arguably the Kentucky wife is also a "co-owner" by virtue of the vested dower interest in her husband's property during marriage. However, *Chalk v. Chalk* indicates the untenable nature of this argument by noting that dower attaches when the spouse acquires property and vests only upon the spouse's death. *Chalk* is consistent with the recognized interpretation of dower and with Kentucky law which requires the spouse to survive her partner to share in his intestate estate. Since dower vests only upon death, it is not a descendible interest but an "inchoate right..."
does] not even remotely reach the dignity of co-ownership."53

The third factor to consider is whether the wife in Ken-
tucky has the right to receive more than a reasonable share of
her husband’s property upon divorce. In Davis,44 the Delaware
wife shared in her husband’s property only to the extent the
court deemed reasonable.55 The wife’s financial condition, her
health and age, her needs in relation to her social position, the
number and ages of the children, and the husband’s earning
capacity were factors the Delaware state courts reviewed in
dividing the property.56 Since the enactment of the Uniform
Marriage and Divorce Act,57 Kentucky courts divide the mari-
tal property in just proportions considering all relevant factors,
including financial and in-kind contribution of each spouse to
the acquisition of marital property; value of nonmarital prop-
erty; duration of the marriage; and the economic circumstan-
ces of each spouse when the property division is to become
effective.58

The procedures in Kentucky for division of property are
dissimilar to those of Delaware because Kentucky recognizes
the wife’s in-kind contribution to the acquisition of marital
property. For example, the value of a wife’s services as a home-
maker is considered to be a contribution to the acquisition of
marital property. Furthermore, all property acquired during
couverture is presumed to be marital property regardless of
title.59 Despite these differences, the Tenth Circuit’s decision in
Wiles v. Commissioner60 suggests that the Kentucky system of
property division does not result in co-ownership to the extent
necessary to satisfy the “traditional” interpretation of Davis.

Wiles involved the Kansas system for the division of prop-
erty upon divorce, a system much like that currently used in
Kentucky. In Kansas, divorce courts are required to marshal
all of the jointly-acquired property, regardless of title, and div-

54 Id.
56 370 U.S. at 70.
60 499 F.2d 255 (10th Cir.), cert. denied, 419 U.S. 996 (1974).
ide it in a just and reasonable manner.61 The contribution of each party, the earning capacity of each party, the source of the property, fault, need, ages, and length of marriage are taken into consideration.62 The Wiles court held "[t]hese factors . . . inconsistent with the idea of co-owned property. If the wife were a co-owner . . ., her interest in the property to be divided would be based on more than a right to a 'just and equitable' share therein."63 Because the Kansas and Kentucky provisions for the division of marital property are very similar,64 transfers in Kentucky would not appear to qualify for tax-free status under the traditional approach.

Since a just division of the property considering all the relevant factors does not entitle the wife to "more than a reasonable share,"65 the wife must be entitled to an absolute percentage of the property upon divorce, to meet the third criterion of ownership.66 Therefore, a system similar to the one in California, where the wife is granted one-half of the community property upon divorce,67 would be the only type that would appear to satisfy the above ownership test under the traditional approach to Davis. But Kentucky law does not grant the wife a uniform, definite percentage of the marital property,68 even though the recent Kentucky Court of Appeals case of Herron v. Herron69 held that the wife's contribution to the accumulation of marital property should be presumed equal to the husband's in a marriage which has endured for a long period and where accumulation of the marital property has been modest. In this situation, the property should be equally divided between the spouses absent a rebuttal of the contribution presumption.70 The traditional approach is based on "the presence

61 KAN. STAT. § 60-1610(c) (1976).
62 499 F.2d at 257-58. See text accompanying notes 104-09 infra for the factors taken into consideration under Kentucky law.
63 Id. at 258.
64 Compare KAN. STAT. § 60-1610(c) (1976), regarding the disposition of jointly-acquired property, with KRS § 403.190 (Supp. 1976), which provides for the division of marital property. The Kentucky statute provides that property shall be divided "in just proportions." Id.
65 See 499 F.2d at 257-58.
66 See Note, supra note 32, at 110.
68 KRS § 403.190 (Supp. 1976).
70 Id.
or absence of significant meaningful attributes of ownership arising under state law on the part of the wife." It is doubtful that the Herron rebuttable presumption of equal distribution qualifies as a significant attribute of ownership. Although the presumption may be analogized to a defeasible title, it is merely an evidentiary tool that shifts the burden of producing evidence. In addition, until the Kentucky Supreme Court clarifies the issue of "percentage distribution," the Herron presumption will not be determinative in federal tax cases since federal courts are not bound by decisions of intermediate state appellate courts. Thus, the Davis rule requiring the taxation of transfers of appreciated property upon divorce would seem to apply in Kentucky under the traditional approach.

B. The Equitable Approach

1. The Collins and Imel Cases

The equitable approach to the Davis decision de-emphasizes the common-law indicia of ownership. Courts emphasizing the equitable approach, such as the Tenth Circuit in Collins v. Commission, contend that a vested interest in marital property arises at the filing of a divorce action, thereby making any transfer incident to divorce non-taxable. These courts substitute this vested interest for the common-law ownership required by those courts employing the traditional approach discussed above.

In Collins an Oklahoma taxpayer transferred shares of stock to his wife pursuant to a divorce agreement. The Commissioner maintained that this transfer was a sale or exchange and levied a deficiency assessment. Because "Oklahoma by statutory command has created unique rights in the [marital] partners . . . [resembling] those found in . . . community

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75 388 F.2d 353 (10th Cir.), vacated and remanded per curiam, 393 U.S. 215 (1968), on remand, 412 F.2d 211 (10th Cir. 1969).
property states,” Collins argued that the transfer was a non-taxable division of property between co-owners. The Oklahoma divorce statute was interpreted by the taxpayer as granting each spouse a vested interest in jointly-acquired property. In Collins I, the federal court used the traditional approach, declaring the transfer a taxable exchange. The Oklahoma statute was not considered to be determinative of federal tax consequences.

Although Collins lost in the Tenth Circuit, he pursued his argument in the Oklahoma Supreme Court. Collins II involved a state tax assessment on the stock transfer; the issues were identical to Collins I. The state’s highest court disagreed with the Tenth Circuit’s conclusion and held that the Oklahoma statute confers upon the wife “a vested interest in jointly acquired property of the marital community.”

Subsequent to Collins II, the Supreme Court, in Collins III, granted certiorari in Collins I, vacated the judgment and remanded it to the Tenth Circuit. In Collins IV, the issue framed by the Tenth Circuit was whether the transfer “more nearly resembles a nontaxable division of property between co-owners, or . . . a taxable transfer in exchange for the release of an independent legal obligation.” The court rejected the traditional approach, held that the vested interest found in

77 OKLA. STAT. ANN. tit. 12, § 1278 (West Cum. Supp. 1977-78). Compare OKLA. STAT. ANN. tit. 12, § 1278 (West Cum. Supp. 1977-78) with KAN. STAT. § 60-1610(c) (1976). Although the Oklahoma and Kansas statutes are nearly identical, the Tenth Circuit held in Wiles v. Comm’r, 499 F.2d 255, 259 (10th Cir. 1964), that the Kansas “wife has no vested co-ownership in property of the husband during the marriage.” See text accompanying notes 60-63 supra for a summary of the Wiles case.

78 388 F.2d at 354. The extent of this vested interest is not established by statute but is determined by the court in an action for divorce. Id.

79 Id. at 357-58.


81 388 F.2d at 357-58.

82 Collins v. Oklahoma Tax Comm’n, 446 P.2d 290 (Okla. 1968).

83 Id.

84 See text accompanying notes 76-78 supra for a discussion of the issues in Collins I.


87 393 U.S. 215 (1968).

88 412 F.2d 211 (10th Cir. 1969).

89 Id. at 212.
Collins II was a sufficient interest for Davis purposes, and concluded that the transfer was a nontaxable division between coowners.\textsuperscript{90}

*Imel v. United States*\textsuperscript{91} involved a Colorado husband who sued for a refund of taxes assessed on appreciated capital assets transferred by him to his former wife in fulfillment of a property settlement agreement. The federal district court certified to the Colorado Supreme Court the question of whether the wife's rights in the marital estate constituted a "species of common ownership."\textsuperscript{92} The Colorado Supreme Court responded affirmatively, concluding that the wife has a vested interest in her husband's property at the time the divorce action is filed.\textsuperscript{93} Appealing the district court's subsequent judgment for the taxpayer, the government argued that a state court cannot determine what constitutes a taxable event under federal tax law.\textsuperscript{94} However, the Tenth Circuit held that ownership is a question for the state courts and that *Davis* does not require vesting of the wife's interest prior to the initiation of the divorce action.\textsuperscript{95}

2. A Comparison of Kentucky Law with Colorado and Oklahoma Law

The law regarding the disposition of marital property in Kentucky, Colorado,\textsuperscript{96} and Oklahoma is almost identical. All three states grant spouses the right to petition the divorce court for a just division of marital property.\textsuperscript{97} While the division of property is mandatory,\textsuperscript{98} the court has discretion in determining the amount to which each party is entitled.\textsuperscript{99} The definition

\textsuperscript{90} Id.
\textsuperscript{91} 375 F. Supp. 1102 (D. Colo. 1974), aff'd, 523 F.2d 853 (10th Cir. 1975).
\textsuperscript{92} 375 F. Supp. at 1116.
\textsuperscript{93} *Imel v. United States*, 517 P.2d 1331, 1335 (Colo. 1974).
\textsuperscript{94} 523 F.2d at 855.
\textsuperscript{95} Id. at 855-56.
\textsuperscript{96} *Colo. Rev. Stat.* § 14-10-113 (1973) and *KRS* § 403.190 (Cum. Supp. 1976) relating to disposition of marital property are derived from the *Uniform Marriage and Divorce Act* § 307 (Alternative B) (1973 amended version).
\textsuperscript{99} *In re Marriage of Lodholm*, 536 P.2d 842, 844 (Colo. 1975); Herron v. Herron,
of marital property in Colorado\textsuperscript{100} and Kentucky\textsuperscript{101} is more specific than the Oklahoma\textsuperscript{102} definition of jointly-acquired property. But this distinction is insignificant since the purpose of all three definitions is to segregate property acquired outside the marital relationship from property acquired by the joint efforts of the parties during marriage.

Once the divorce action is filed with the court, property acquired during coverture is deposited in a hypothetical "hotchpot" and legal title is disregarded.\textsuperscript{103} In effectuating a division, the courts in these states consider the contribution of each party — including homemaker services — to the acquisition of the property.\textsuperscript{104} Marital misconduct is not a factor;\textsuperscript{105} however, the future economic position of each spouse is relevant.\textsuperscript{106} Only Kentucky lists duration of marriage as a consideration,\textsuperscript{107} but Colorado may also give this element some attention since the applicable Colorado statute directs the court to consider all relevant factors.\textsuperscript{108} Disposition of the marital property by the courts is final in all three states and the matter cannot be reopened or modified absent extraordinary circumstances.\textsuperscript{109}

Comparison of the law of the three states reveals one crucial distinction for \textit{Davis} purposes. The highest courts in Colorado\textsuperscript{110} and Oklahoma\textsuperscript{111} have held that the wife has a vested

\textsuperscript{100} COLO. REV. STAT. § 14-10-113(2) (1973).
\textsuperscript{101} KRS § 403.190(2) (Cum. Supp. 1976).
\textsuperscript{102} OKLA. STAT. ANN. § 1278 (West Cum Supp. 1977-78).
\textsuperscript{107} KRS § 403.190(1)(c) (Cum. Supp. 1976).
\textsuperscript{109} McDonald v. McDonald, 374 P.2d 690, 691 (Colo. 1962); Feland v. High, 67 P.2d 967, 969 (Okla. 1937); KRS § 403.250(1) (Cum. Supp. 1976).
\textsuperscript{110} Imel v. United States, 517 P.2d 1331, 1332 (Colo. 1974).
\textsuperscript{111} Sanditen v. Sanditen, 496 P.2d 365, 367 (Okla. 1972). \textit{See also} Lilly, Oklahoma's Troublesome Coverture Property Concept, 11 TULSA L.J. 1, 16 n.90 (1975), where the author argues that the \textit{Sanditen} court should have held that filing of the
right to the marital property once the divorce action is filed. Although the Kentucky Supreme Court has concluded that the wife has "vested 'ownership' interest" in team effort property regardless of title, the Court has not yet held that this interest vests as of the filing of the divorce action. At first glance, the Court's decision in Clark v. Clark seems to indicate that the wife does not have a vested interest in the property when the divorce action is filed, but does have such interest when the final judgment is rendered. A close reading of the case reveals, however, that Clark turned on the law of remedies, and did not confront the issue of when the right to a share of marital property vests in a spouse.

The original judgment in Clark was reversed in part and remanded by the Court for reconsideration in light of the principles established in Colley v. Colley. On remand, the trial court granted the wife 40% of the value of the team effort property, to be paid by the husband in installments. The decree directed the husband to pay interest on these payments from the date of the judgment granting the divorce.

divorce action restricts alienation and that vesting occurs only as a result of the court decree.


In Cooke the trial court awarded the jointly-owned property to the wife even though the husband furnished the initial capital investment. The law at that time required restoration of property to the spouse who furnished the consideration, regardless of title. Affirming the trial court's decision, the Court liberally construed the definition of consideration to include the wife's in-kind contribution. "We see no justifiable reason why the 'happenstance of which party had the cash to put up the original down payment, . . . should be the immutable criterion of 'ownership.' " 449 S.W.2d at 217. Where property has been accumulated by the joint efforts of the husband and wife, both spouses have "a vested 'ownership' interest." Id. at 218.

13 Colley v. Colley, 460 S.W.2d 821 (Ky. 1970). Colley is a landmark opinion which expands Cooke v. Cooke, 449 S.W.2d 216 (Ky. 1969), and requires the division of property acquired during coverture to be based on the respective contribution of each spouse. The Court concluded that the wife's separate earnings or the contribution of her domestic services entitle her to an equitable or titular interest in the jointly-acquired property regardless of record title. 460 S.W.2d at 825. K.R.S. § 403.190 (Cum. Supp. 1976) is a codification of the Colley decision. See Note, Kentucky's New Dissolution of Marriage Law, 61 Ky. L.J. 980, 990 (1973).

14 487 S.W.2d 272 (Ky. 1972).

15 471 S.W.2d 740 (Ky. 1971).

16 460 S.W.2d 821 (Ky. 1970). See note 113 supra for a summary of the Colley opinion.

17 487 S.W.2d at 273.
peal, the Court surmised that pre-judgment interest was awarded on the trial court’s theory that the wife’s right in the joint-effort property became vested once the divorce was granted. The Court reversed, holding that since the wife had “nothing more than an unliquidated claim” against her husband, she was only entitled to interest on the final judgment. The Court found dissolution of a marriage to be unlike dissolution of a partnership, for in the latter, the partners’ share can be ascertained by bookkeeping principles; in the former, the wife’s share can be determined only by the court’s evaluation of many intangible factors.

Clark can conceivably be read two ways. One interpretation would be that the wife has no ownership interest in the property until final judgment. This interpretation is consistent with the traditional approach and contrary to the equitable approach, under which the wife has a vested ownership right at the moment the divorce action is filed. It seems clear, however, that Clark simply expressed adherence to the rule that courts refuse to award pre-judgment interest on unliquidated, unascertainable claims. This reading explains the Court’s comparison of a marriage to a business partnership. When a partnership is dissolved, a partner’s claim, although unliquidated, is ascertainable; consequently, pre-judgment interest is awarded. By contrast, the wife’s share is not immediately ascertainable; therefore, pre-judgment interest is not appropriate. Thus Clark does not indicate the opinion of Kentucky’s highest court on when the right to a share of marital property vests in a spouse. Absent a resolution of this issue by the Kentucky Supreme Court, federal courts may refuse to apply the equitable approach used in Collins and Imel.

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118 This theory could currently have some impact on the Kentucky appellate court decisions, since James Park, Jr., trial judge in Clark, id. at 272, presently sits on the Kentucky Court of Appeals.
119 Id. at 274.
120 Id.
121 See text at Part II(A) supra.
122 See text at Part II(B)(1) supra.
124 See Curtis v. Campbell, 336 S.W.2d 355, 361-62 (Ky. 1960), the partnership case referred to by the Court in Clark, 487 S.W.2d at 274.
125 487 S.W.2d at 274.
126 See text at Part II(B)(1) supra.
C. The Progressive Approach

Prior to the enactment of Kentucky Revised Statutes § 403.190, the divorce court was required to divest a wife of property held in her name if it was obtained solely as a result of her marriage, rather than by her financial contribution. Ownership rights in this property were then restored to the husband who had furnished the monetary consideration. The Sixth Circuit decided Swaim v. Commissioner when this restoration system was still in effect.

In Swaim, the husband and wife purchased a home during coverture and took title as joint tenants. Later they sold the home, and both husband and wife received separate but identical promissory notes as payment. The wife's promissory notes were restored to the husband in a divorce proceeding on a finding by the court that the husband had furnished the entire purchase price of the home. When the husband subsequently transferred one of these restored notes to the wife pursuant to the divorce decree, the court was asked to determine whether the husband realized a taxable gain. The Sixth Circuit decided that since the "restoration statute affects the substantive property rights of the parties to a divorce proceeding," the trial judge's determination of ownership — based upon whether the property was obtained solely due to the marriage — controls, and the transfer was declared to be a taxable event.

The novelty of the Sixth Circuit approach is due to the fact that it allows the divorce court's decision regarding ownership to dictate the outcome in federal tax litigation. Unlike the traditional and equitable approaches, Swaim does not require either a consideration of the traditional criteria of ownership or a ruling by the state's highest court that the provider of the monetary consideration has a vested interest in that property regardless of legal title once the divorce action is filed. Swaim,

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127 (Supp. 1976) [hereinafter referred to as KRS].
129 Smith v. Smith, 436 S.W.2d 532 (Ky. 1969).
130 417 F.2d 353 (6th Cir. 1969).
131 Id. at 354.
132 Id. at 354-56.
133 Id. at 357.
134 Id. at 357-58.
135 See text accompanying notes 38-40 supra.
therefore, not only extends and redefines the concepts behind the equitable approach, but also demonstrates that ownership prior to a divorce proceeding is not necessarily dispositive of whether a transfer constitutes a taxable event, and that a state statute can confer ownership rights upon divorce irrespective of paper title.138

The analysis utilized in Swaim can be applied to KRS § 403.190, the current statute which determines disposition of marital property in Kentucky. Section 403.190 affects substantive property rights137 for purposes of applying Swaim, to the same extent as the restoration statutes did previously.138 Both the former and present statutes ignore paper title in a determination of ownership.139 While the restoration statutes based ownership on financial contribution,140 KRS § 403.190 predicates ownership on in-kind contribution as well as valuable consideration. Thus, just as the court in Swaim disregarded the wife's title and conferred ownership on the husband because he furnished the monetary consideration,141 the court could now ignore the husband's title and declare the wife the owner based on her in-kind contribution.

For example, assume that the husband is the fee simple owner of a residence and a farm. Assume further that in a divorce proceeding, the court divides the marital property pursuant to KRS § 403.190 and grants the wife the residence in fee simple. Using the Swaim approach,142 the court's determination of ownership — based on the factors listed in the statute — controls, and the husband incurs no tax liability when the residence is transferred. The outcome is identical to that of the equitable approach.143 Courts advocating the traditional approach may challenge the Swaim court's disregard of paper title in defining a taxable event. Nonetheless, just as the law confers ownership rights on the adverse possessor144 and the

134 417 F.2d at 357-58.
137 See, e.g., Browning v. Browning, 551 S.W.2d 823, 824 (Ky. App. 1977).
138 See text accompanying notes 133-34 supra.
140 Eckhoff v. Eckhoff, 247 S.W.2d 374, 375 (Ky. 1951).
141 417 F.2d at 357-58.
142 See text accompanying notes 130-33 supra.
143 See text at Part II(B)(1) supra.
144 See, e.g., Ely v. Fuson, 180 S.W.2d 90 (Ky. 1944); KRS § 413.010 (1970).
grantee of a deed, it can also confer ownership on the wife who contributes in-kind services to the acquisition of marital property.

The Swaim approach may also be criticized as a mechanical application of a state trial court's adjudication of ownership to a federal tax question. Such criticism should not preclude utilization of this approach. The Supreme Court held in Commissioner v. Estate of Bosch that federal authorities are not bound by a state trial court's ruling on state law when a case involves a federal question. The Court, however, did not forbid the federal courts from utilizing determinations of state law made by lower-level state courts. In considering the taxability of a divorce-related transfer of appreciated property, federal courts should determine the wife's ownership rights in the marital property by applying substantive state law and giving proper regard to the trial court's conclusions.

### Summary and Conclusion

In common-law states, the application of the principles announced in United States v. Davis determines whether a divorce-related transfer of appreciated property by the husband to the wife will be a taxable event. The husband realizes income in the amount of the appreciation if the wife's marital rights in his property include only inchoate dower and the right to a reasonable share of his property upon divorce. The Supreme Court has described these rights as being closer to a burden on the husband's property that a bona fide property interest. In this situation, the Davis court held that the transfer was a taxable transfer of appreciated property in exchange for the release or satisfaction of a personal obligation, rather than a tax-free transfer in satisfaction of a pre-existing property interest.

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146 KRS §§ 381.060(2), 381.170 (1970).
147 See Legget v. Comm'r, 329 F.2d 509 (2d Cir. 1964).
149 Id. at 465.
150 This is essentially what the Sixth Circuit did in Swaim v. Comm'r, 417 F.2d 353 (6th Cir. 1969), where it examined state law, as established by the statutes and Kentucky's highest court, in reaching a determination on the issue of taxation while affording proper regard to the trial court's conclusions.
There are three varying interpretations of the *Davis* case in the federal courts: the traditional approach, the equitable approach, and the progressive approach. The traditional approach, used by the majority of federal courts, establishes the power to manage or dispose, the right to a descendible interest, and the right to some percentage of property (other than a reasonable share upon divorce) as the rights a wife must have in her husband’s property to be deemed a co-owner for income tax purposes. In Kentucky the wife does not have the right to manage or dispose of her husband’s property, nor does she have a descendible interest. The Kentucky statutory scheme (where all jointly-acquired property is commingled upon divorce and a just division is made based on the contribution of the parties, duration of the marriage, economic circumstances of the parties, and other relevant factors) does not give the wife anything other than a reasonable share upon divorce. Consideration of the factors of the Kentucky scheme is inconsistent with ownership under the traditional approach. Consequently, the *Davis* rule of taxation applies to Kentucky if courts use the traditional approach. One of the effects of this view of *Davis* is that the husband may prefer a cash settlement to a taxable transfer of appreciated property. The wife is then left with a fluid asset subject to inflation and the possibility of installment obligations which subsequently may have to be enforced in court.

The equitable approach has been followed by the Tenth Circuit and applied to divorce in the common-law states of Colorado and Oklahoma. The supreme courts of these states have concluded that the wife has a vested property interest in the marital property once the divorce action is filed. As a result, the Tenth Circuit has determined that the transfer of appreciated property by the husband upon divorce is more like a division of property between co-owners than a transfer in relinquishment of a personal obligation. Consequently, the transfer is treated like those in community property states and no income is realized by the husband for federal tax purposes.

Kentucky's disposition of marital property statute is almost identical to the statutes of Colorado and Oklahoma. The Kentucky Supreme Court, however, has not yet determined that the wife has a vested interest in the marital property once the divorce action is filed. Until such a decision is rendered, it is unlikely that the equitable approach will be applied by the
federal courts to eliminate the tax consequences of Davis on divorce-related transfers of appreciated property in Kentucky.

The progressive approach was applied by the Sixth Circuit when Kentucky’s restoration statutes, now repealed, were in effect. Upon divorce, the restoration statutes divested the spouse of title to property if he or she had not financially contributed to its purchase. In Swaim v. Commissioner, the Sixth Circuit recognized that the restoration statutes substantially affected the property rights of the husband and wife. Applying the state trial court’s interpretation of state law, the court of appeals concluded that even though the wife held legal title to the property, the husband was the rightful owner since he had furnished the consideration therefor. The husband was taxed when the wife ultimately received the property pursuant to a divorce decree.

This approach, when applied to Kentucky’s current divorce law, results in a tax-free transfer. The applicable statute, KRS § 403.190, requires the courts to ignore legal title and divide the jointly-acquired property on the basis of each party’s financial or in-kind contribution, the duration of the marriage, economic circumstances of the spouses and other relevant factors. The Kentucky Supreme Court has made it clear that KRS § 403.190, like the former restoration statutes, affects substantial property rights of the parties. If the wife is adjudged the owner of a certain portion of the marital property based on her contribution to its acquisition, then the Sixth Circuit approach will disregard the transfer of bare legal title by the husband. This method is superior to the traditional view since it recognizes that ownership rights can be created by statute as well as by common law. Other states having statutes similar to Kentucky would also benefit if this progressive approach were utilized. The husband would not be burdened with increased tax liability and the wife would be in a better position to negotiate for valuable property.

Unlike courts using the traditional approach, the Sixth Circuit does not demand that state law grant the wife an absolute percentage of the marital property upon divorce in order

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152 417 F.2d 353 (6th Cir. 1969).
for her to be deemed a co-owner. The progressive approach affords a state some flexibility by permitting the division of team effort property based on each party’s contribution to the marriage. Because each marriage is unique, this is probably the fairest method of dividing marital property. The progressive approach is also preferable to the equitable approach because it refuses to rely on fictitious labels of ownership supplied by state supreme courts. On the other hand, mechanistic application of a state trial court’s adjudication of ownership to a federal tax question could be dangerous. However, this criticism would be unfounded if state law were carefully examined before a decision was rendered. The progressive approach will function well, provided a federal court assumes the same posture as the state’s highest court when it determines the property rights of the wife who has received appreciated property pursuant to a divorce. The Sixth Circuit approach is legally sound, achieves a just result, and should be applied to divorce-related transfers of appreciated property in Kentucky to eliminate the harsh tax consequences of the Davis rule.\(^1\)

Susan L. Coleman

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\(^1\) A party to a divorce proceeding in Kentucky may wish to contest the applicability of Davis using the equitable or progressive approach. If so, the party’s lawyer should itemize the non-marital and marital property in the property settlement agreement and expressly designate the marital property which constitutes the separate ownership interest of each spouse. If appreciated property (such as shares of corporate stock) held by the husband is to be transferred to the wife to effectuate the terms of the property settlement agreement, it may be advantageous to both parties to execute an escrow agreement simultaneously with the property agreement. The escrow agreement would enable the parties to divide the tax liability on the transfer if Davis were held applicable and would provide a method whereby payment of such contingent tax liability would be secured. Specifically, the escrow agreement should provide that the wife agrees to pay one-half (or some other portion) of the tax in the event the Internal Revenue Service successfully challenges the husband’s argument that the transfer was not a taxable event but rather a division of property among co-owners. To secure the wife’s payment of this contingent tax liability, the escrow agreement should provide that the wife shall deliver a portion of the appreciated property (e.g., 25% of the corporate stock transferred by the husband) to a named escrow agent upon execution of the agreements. If the tax liability becomes due and the wife does not pay the husband her portion of the amount owed, then the escrow agent should be empowered to sell such of the shares of stock in escrow as are necessary to pay the wife’s portion of the taxes due. If, on the other hand, the wife pays her portion of the tax liability or it is determined that the transfer constituted a non-taxable event or upon the expiration of the period of limitations, the escrow agreement should provide that the escrow agent shall transfer such stock to the wife. During the period that the stock is in escrow, the wife should be entitled to all the privileges of ownership of the stock, including voting rights and the right to all dividends.